

Otmar Issing: Evaluation of the ECB's monetary policy strategy

Opening remarks by Professor Otmar Issing, Member of the Executive Board of the European Central Bank, at the European Central Bank Watchers Conference, Frankfurt, 11 July 2003.

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Introduction

I welcome the opportunity to address this fifth edition of the ECB Watchers conference. This annual meeting has become a tradition by now. It is a remarkable tradition: to my knowledge, the ECB is the only central bank that regularly intervenes in meetings of this kind. When, four and a half years ago, the ECB started conducting monetary policy for the euro area, we decided to participate in this initiative launched by the CFS as we felt the need, as a new central bank, to quickly establish active channels of debate with the market, academic, and press communities. We now continue to benefit from these meetings on a regular basis. I wish to thank Prof. Weber for proposing this formula and for maintaining his commitment over the years.

This meeting is a special one. In the course of the last year the ECB has launched, conducted and concluded an evaluation of its monetary policy strategy. A good deal of the remarks today naturally focus on such evaluation, its conclusions as announced on 8 May, and the changes - or lack of changes - that this review process led to. Accordingly, my short remarks this morning will be centered on three points:

1. Why has the ECB decided to undertake an evaluation of its strategy;
2. How was this evaluation conducted;
3. What conclusions we reached, and why.

Why an evaluation of the strategy?

Many people were surprised by the announcement, last December, that the ECB would undertake an evaluation of its monetary policy strategy. Some took it as an implicit indication that we were dissatisfied by the strategy and prepared to change it. The opposite is true.

When our strategy was announced, on October 1998, the ECB had not yet assumed its responsibility of conducting monetary policy for the euro area. The strategy we designed was a novel one, suited for the special characteristics of the euro area and its central bank, and different in a number of respects from other current and past strategies. It incorporated the best judgement and experience of central banks and the key lessons of economic research, but it lacked one fundamental element: the test of practical experience. Hence it was only natural that, after a period of time, the Council would want to go back and reflect on the accumulated experience in a systematic way. This did not mean that changes were necessarily needed - any more than a new car necessarily needs repair when it is taken to the garage for its 5,000 miles checkup! It is true, however, that we undertook our evaluation with an open mind, ready to introduce changes in case our evaluation had suggested the need to do so.

There are in my view three areas where a monetary policy strategy plays a crucial role in a central bank, and this is where our attention focused:

1. *The strategy should provide a framework for the internal analysis.*

As such, the framework must encompass and organize all relevant information in an efficient way. It should use the best available research, taking into account all different sources of uncertainty the central bank faces. Competing models must be allowed to paint complementary pictures of the economic outlook and the risks to price stability.

2. *The strategy should also provide a framework for the debate within the decision making body.*

From this viewpoint, the strategy must be efficient in terms of allowing the decision making body to examine and weigh all relevant information, encompassing any diversity of views that may exist on the transmission mechanism.

3. *Finally, the strategy should provide a framework for external communication.*

Here, transparency and effectiveness are linked. Effective communication facilitates the transmission of monetary policy decisions to the economy. At the same time, using the same framework for external communication as for internal analysis should guarantee consistency and improve public understanding of how monetary policy is conducted, thereby enhancing transparency and effectiveness at the same time.

How was the evaluation conducted?

Accordingly, we went through several steps. The first was to revisit all the technical issues. All aspects of the strategy were scrutinized, going through a lively internal debate and resulting in a series of technical studies now available on our web site. The key role here was played by the staff of the ECB and of the National Central Banks, the latter contributing through the Eurosystem Monetary Policy Committee. Use was made of research accumulated during the recent years, in the ECB and outside, on a number of issues relevant for the strategy, such as the transmission of monetary policy, the determinants of prices, the leading indicator properties of money, credit and other key indicators, and the like.

The second step was to reflect on how the strategy has contributed to the debate within the ECB decision making bodies, naturally with a particular focus on the Council. In the decade leading up to the EMU, a broad consensus on the principles of sound monetary policy making emerged among the NCB's now forming the monetary union. Even so, the ECB Governing Council is a large body, with a wealth of diverse experiences and views. The strategy must provide a commonly accepted framework within which these experiences and views all contribute to policy decisions. The strategy should also ensure that the relevant information is taken into account fully and orderly. From this point of view, the ultimate test for the success of the strategy are the extent to which it effectively guides the debate within the Council and the record of actual policy decisions. I think it is fair to say that most observers agree that the ECB's record has been, on the whole, very successful in these four and a half years.

Finally, we carefully considered the performance of the strategy in external communication. This is an area where, according to several observers, including some present here today, the strategy has worked less well. We have examined the full range of views, including those coming from the Watchers' meetings and those expressed by market participants, academics, and the press. Our announcements regarding the strategy on 8th May, which I am now going to discuss briefly, are aimed primarily at addressing certain misunderstandings that have emerged in our communication with the public.

The result of the evaluation

I do not need to discuss here all aspects of our review; the documents in our website provide a complete account of them. The issues we investigated included the choice of the specific index used to define price stability, the preference accorded to headline as opposed to "core" inflation, how to deal with inflation differentials within the area, the stability of the euro area money demand function, and many others.

I will limit my remarks to the two most debated aspects: the definition of price stability and the role of money, or the "two-pillar structure" of the strategy.

The definition of price stability

Regarding the definition of price stability, the Governing Council confirmed the explicit quantitative definition announced already in October 1998, which is based on an objective and transparent

measure, as provided by the HICP. We remain convinced that this is an important element of clarity, that contributes positively to both the effectiveness of policy and to the ECB's accountability.

Moreover, the Council noted that this quantitative definition had been very successful in anchoring market expectations. The direct and indirect measures of expected inflation in the euro area have shown a remarkable stability in the last few years, at a level just below 2%. This is a very important result, perhaps the most important, for a central bank whose mandate is to maintain price stability over the medium term. Hence, the essence of the existing definition of price stability, namely, a year-on-year increase in the Harmonized Index of Consumer Prices for the euro area of below 2%, was fully confirmed.

At the same time, the Governing Council clarified that in the pursuit of price stability it will aim to maintain inflation rates below, but close to 2% over the medium term. This clarification emphasizes the need for a sufficient safety margin against the risk of deflation.

There are several good reasons for accepting a low rate of inflation. The major concern is the fact that monetary policy may become less effective, if interest rate management by the central bank is constrained by a liquidity trap or a "zero bound" problem. ECB analyses show that such constraint should not pose a significant threat if inflation remains sufficiently above zero. The clarification we provided to the price stability definition offers a safeguard in this sense.

In preventing the emergence of deflationary and inflationary dynamics alike, a forward-looking orientation of monetary policy is essential. There is no convincing evidence that relying on rigid rules helps in this respect. Rather, the medium term orientation of the ECB strategy, with its explicit reference to all relevant indicators of future price developments, provides flexibility and forward-looking orientation while maintaining a firm reference to the medium term price stability goal.

The role of money and the two-pillar framework

The Governing Council confirmed that the two-pillar framework of the strategy is an effective tool to organize the information on different risks to price stability. Different types of analysis provide information relevant for price developments at different time horizons. The economic analysis - focusing on the most proximate causes of inflation such as cost developments and demand-supply imbalances - primarily contributes to assess *short to medium-term* economic developments and consequently risks to price stability at that horizon. The monetary analysis - focusing instead on the ultimate monetary determinants of inflation - primarily contains information for assessing price developments at *medium to long-term* horizons. The economic literature suggests that there is no easy way to bring together the monetary analysis with the economic analysis in a unified framework; or, as we could say more technically, to integrate money and credit into today's standard macroeconomic models. In this respect, the monetary analysis mainly serves as a means of cross-checking, from a medium to long-term perspective, the short to medium-term indications coming from economic analysis. In particular, to underscore the longer-term nature of the reference value for monetary growth, which is retained as a benchmark for the assessment of monetary developments, the Governing Council decided to discontinue the practice of an annual review.

The ECB's monetary policy strategy will continue to provide a solid basis to tackle further challenges ahead. I am sure that over time the merits of our approach will be fully recognized. It is very open and transparent about the presence of the uncertainty surrounding the functioning of the economy and the reliability of key economic relationships, which necessitate a diversified approach. In particular, a prominent role for money underpins the medium-term orientation of monetary policy and helps eschew excessive policy activism and overly ambitious attempts to "fine-tune" economic developments. The two-pillar strategy also provides a suitable framework to take asset price developments appropriately into account.

More than four years of experience provide evidence of the success of the strategy as the basis for monetary policy decisions in the face of significant uncertainty and sizable adverse shocks. The evidence shows that the ECB is on the right track. It has earned credibility, fulfilled the stability mandate given to it by the Treaty and will continue to do so. This is in the end what counts.

Conclusions

In concluding let me stress, as I always do when discussing these issues, that our reflection on the strategy is an ongoing process. It did not start with the recent evaluation and will not end with it. We continuously reexamine the performance of our strategy while we work with it.

Hence I am sure that your job as Watchers, and occasionally as critics, is not finished. We continue to look forward to your feedback and need your constructive critique, not only in the short term - but also over the medium to long term.